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Chinese Capital Markets: Institutional Reforms and Growing Global Links*

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1. Introduction

The University of Edinburgh Business School hosted the 3rd Conference on the Chinese Capital Market on the 1st and 2nd 2013. The conference attracted more than 70 submissions from scholars all over the world and 15 papers were invited for presentation at the conference. Following the standard double blind review process, 10 papers appear in this special issue.

The keynote speakers were Franklin Allen from the Wharton School, University of Pennsylvania (now at Imperial College, London) and Kalok Chan from the Hong Kong University of Science and Technology (now at the Chinese University of Hong Kong). Professor Allen's keynote address was on finance and growth in China. In particular, he covered what economic lessons can be learned from the remarkable performance of China’s economy?

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Is China simply applying conventional wisdom, which is to copy European and US development, or doing something fundamentally different that Western economists and lawyers have yet to fully understand? He argued that Chinese firms on the mainland and later in Taiwan did not use the provisions of the law but again conducted commerce outside the legal system. The alternative to law in assuring performance is other mechanisms such as reputation, connections and networks and positive financial incentives. In a dynamic environment, the use of the legal system is not optimal because of barriers to change. The suggestion is that Asian countries like China are successful because of their lack of Western institutions and their use of alternative institutions.

Professor Chan's keynote was based on his study, Cakici et al (2017), entitled *Cross-sectional stock return predictability in China*, which evaluates 10 stock return predictors in the Chinese stock exchanges over the sample period of 1994 to 2011. Consistent with the empirical evidence from studies of Western developed economies such as the US market, this study reveals significant predictive power for size, price, book-to-market ratio, cash-flow-to-price ratio, earnings-to-price ratio, as well as total and idiosyncratic volatility. Interestingly and unlike evidence from the US market, this study provides mixed evidence on the return momentum effect, which exists mainly when used with other predictors and for large stocks. This study has important implications for investment practitioners as well as market regulators in China, which is a high growth and rapidly developing economy in which stock exchanges plays an important role in the allocation of financial capital to listed firms. On the one hand, evidence of stock return predictabilities suggests that there could be security mispricing opportunities and profitable trading strategies for equity investors in the Chinese stock exchanges. As such, investment in skilfully managed active funds could yield higher returns, although issues such as transaction costs and risk adjustment may require attention. On the other hand, such evidence also suggests limitations in the level of information efficiency in the

Chinese stock market. There is room for market regulators to strengthen corporate disclosure quality and information dissemination to protect the interest of investors.

2. Contributions in the special issue

In this section, we summarize the findings and implications of the 10 accepted articles. Chen et al. (2017), titled *what happens when firms break promises? The case of information credibility*, studies the consequence of firms using the capital raised from IPOs (Initial Public Offerings) or SEOs (Seasonable Equity Offerings) on projects different from the ones specified in the prospectuses. In particular, they focus on the firms that simultaneously announce the new investment and terminate the originally specified projects and interpret this scenario as promise-break which implies decreased information credibility. Negative CARs (Cumulative abnormal returns) are documented following the project-change announcement, especially in the firms with concentrated ownership or with fund ownership. This studies explore a unique dataset from the Chinese market and adds to the literature on the information credibility. Future studies can examine the managerial decision when CEO faces the trade-off between pursuing new projects with more positive NPV (net present value) and keeping the promise.

Hu et al. (2017), titled *can independent directors improve internal control quality in China*, examines whether independent directors' monitoring power influences the internal control quality (ICQ) of Chinese listed firms. The monitoring power index is constructed by considering independent directors' financial expertise, incentives, balancing power and diligence. The index is found to increase the likelihood of disclosing auditors' opinion on internal control and decrease the likelihood of financial restatements. The findings contribute to the literature on the effectiveness of independent directors in China. Future studies can examine the boards' self-assessment on internal control, which has been suggested to be disclosed by Shanghai and Shenzhen Stock Exchanges since 2006.

Dedman et al. (2017), titled *the value relevance and information content of case and stock dividends in China*, examines two issues. First, why firms issue stock dividends and sometime simultaneously pay cash dividends? Second, why do investors positively respond to these events? They examine the Chinese setting, where arguably the information content of these events is particularly important, and where they have been exogenous regulatory reforms that enable informative empirical tests. They find that both cash and stock dividends are very common in China. Where cash dividends have limited capacity to convey information, then stock dividends appear to be used for this purpose. After the split-share structure reform and the convergence of Chinese financial reporting with IFRS, cash dividends become more informative, while stock dividends appear to contain less value relevant information.

Cumming et al. (2017), titled *The value of home-country governance for cross-listed stocks*, studies the effect of both home country shareholder- and sovereign-governance on non-US firms that cross-list in the United States. They test the bonding and the market segmentation hypotheses and shows that cross-listing in the United States may help companies to overcome a poor shareholding-governance environment, without removing the effect of weak sovereign-governance. Their findings contribute to the cross-listing literature by addressing the interplay between home-country regulation, sovereign credit risk, and governance. The findings have important implications for the increasing number of Chinese companies that cross-list in Canada and the United States. Future studies may address the following two issues: The effect of domestic heterogeneity in country- and firm-level governance on value- and growth-stocks; and the impact of sovereign governance on the investors' choice of trading locations of cross-listed firms.

Schweizer et al. (2017), titled *are informed traders sensitive to regulatory environments,* empirically analyses how regulatory regimes affect investor's trading decisions. More specifically, they study the informed trading of options on U.S.-listed companies and for those with dual listings in China. They find strong evidence that informed traders opt to trade in markets where regulatory oversight is low. Where regulatory oversight is high, informed traders are less likely to exploit their private information. Adcock *et al*. (2017), titled *Derivative activities and Chinese banks' exposures to exchange rate and interest rate movements*, addresses how the use of derivatives affects Chinese credit institutions' vulnerability to exchange rate and interest rate fluctuations. First, they allow these exposures to be dependent on time-varying firms-specific characteristics. Second, they make use of orthogonalised market returns to compute the time-varying exposure of Chinese banks. Third, they introduce the possibility of a non-linear relationship between exchange rate fluctuations and corporate cash flow. Making use of a panel estimation, they show that banks which make use of derivatives are able to reduce their exposure to foreign exchange risk, but record no effect on the interest rate risk. A policy implication of their findings is that the authorities should be able to strengthen the credit system by pushing banks to make a wider use of derivatives targeted towards risk management purposes.

Dong et al. (2017), titled *the Impact of Foreign Bank Penetration on the Domestic Banking Sector: New Evidence from China*, studies the rapidly explained branch networks of local and foreign Chinese banks. They create an index of competition from foreign banks in terms of geographic proximity. They data indicate that foreign bank competition is associated with improved profitability at domestic banks, higher efficiency, and increased non-interest income. These findings are consistent with knowledge transfer from foreign banks.

Aitken et al. (2017), titled *Trade size, high frequency trading, and co-location around the World*, examines the extent to which modifications in the market microstructure influence the number of trade shares (the "trade size") following the rise of Algorithmic Trading (AT) and High Frequency Trading (HFT). In order to establish the impact of HFT on marketplaces, one needs to identify the start-date of HFT in different exchanges. Given the lack of such information, the author makes use of a unique international dataset collected by hand. He then shows that HFT pre-dates co-location on most exchanges, and that co-location services do not appropriately measure AT and HFT, being rather the outcome of HFT. The study contributes to the literature along three avenues. First, it shows the effect of HFT on trade size. Second, it tests whether exchanges endogenously decide to offer co-location services. Third, it supplies a new approach to determine the presence of HFT in a selected market. Future research could examine the causes and the effects of variations in trade size, with particular reference to the case of China.

Dixon et al. (2017), titled *Managerial ownership, corporate governance, and firms' exporting decisions: Evidence from Chinese listed companies*, examine the relationship between firms' exporting decision and corporate governance characteristics, based on a sample of Chinese listed firms over the period of 2004 to 2010. It provides evidence that managerial ownership increases export propensity and intensity up to a point but decrease thereafter. Further analyses reveals that export is negatively associated with state ownership, board size, and board independence, and that these findings are more pronounced among privately-controlled firms during the post-2006 period. This study intersects the corporate governance and international trade literature, and has important implications since export plays an important role in China's economic growth and development For instance, managerial ownership appears to be an effective approach to incentivize export activities, although its non-linear effect needs to be taken into account in the actual application. Aside from this, since board characteristics appear to have an influence on export decisions, attention needs to be paid on the size, quality, and expertise of board members. Beyond China, the paper also has important implications to other emerging economies, as it demonstrates that policy makers can promote export activities and international presence by regulating corporate governance mechanisms.

3. Discussions and future research

The recent institutional reforms in China provide new settings to explore various important topics in finance. Some of them are potential exogenous shocks which can be used to address the endogeneity issue and make causal inferences. The three major reforms are namely the Anti-Corruption Campaign, Mass Entrepreneurship and Innovation and the Belt and Road initiative (also known as the land and maritime Silk Road initiative). In addition, China Securities Regulatory Commission has recently issued a wide range of new or revised regulations. Table 1 summarises the regulatory reforms on public offering, listed firms, trading rules, securities firms, funds, derivatives and other aspects. Many policies aim to enhance investor protection.

The legal institutions in China are relatively weak. Due to weak legal institutions, private firms often suffer from rent seeking, government expropriation, extra tax burdens and limited financing opportunities (Allen et al., 2005). The Anti-Corruption Campaign was launched by Xi Jinping on 4 December 2012. Lin et al. (2016) document positive market reactions for state-owned enterprises (SOEs) and the sub-sample of non-SOEs from provinces with more developed market institutions and with higher prior productivity, greater external financing dependence, and greater growth potential. In areas with under-developed market institutions, the campaign limits firms' ability to realise the benefits of connections that was been established at costs. Pan and Tian (2017) find that firms connected with prosecuted corrupt government officials declines significantly. Zhang (2016) shows that the anti-corruption campaign reduces Chinese firms' incentive to commit fraud. Future studies can examine the impact of the reform on firms' long-run performance, regional economic growth, executive compensation, research and development and entrepreneurial activities.

Nonetheless, there is substantial room for improvement. The recent 2016 Corruption Perceptions index by Transparency International placed China the 79th in the world, sharing the same rank with Brazil, India and Belarus. The 2016 Rule of Law Index by the World Justice Project ranked China 80th in the world, next to Zambia. The underlying reasons for China to achieve the development miracle under weak legal institutions remain unclear. For example, An et al. (2017) identify *xinfang*, a channel administrated by the government that resolved more disputes than the judicial system, as an additional fundamental institution for investor protection. We encourage more studies on the alternative institutions that sustain China's development.

On 26 September 2015, the Chinese government issued *Opinions of the State Council on Several Policies and Measures for Vigorously Advancing the Popular Entrepreneurship and Innovation* that marked the start of the Mass Entrepreneurship and Innovation. Following the regulation, many provincial and municipal governments regularly organize venture competition and provide substantial support in terms of interest-free loans, subsidies and free incubator service and facilities. Many fresh graduates from the universities are encouraged to start their business. In addition, talent schemes and new policies on attracting returnee talents and foreign experts were also issued, making the "green card" less impossible. While Trump curbs immigration, China eases green card (permanent residence) rules. We encourage future studies to examine the effectiveness of the policies. For example, to what extent such subsidies help start-ups overcome the financial constraints and whether the subsidies are put to good use?

On 28 March 2015, the Chinese government issued *Vision and proposed actions outlined on jointly building Silk Road Economic Belt and 21st-Century Maritime Silk Road*, which marked the launch of the Belt and Road Initiative. The Silk Road refers to the business routes connected ancient China with other countries in Asia, Africa and Europe. Chinese firms directly invested more than 49 countries along the Silk Road and the investment increased by 18.2% from 2014 to 2015. The Belt and Road Forum for International Cooperation was held on 14-15 May 2017 in Beijing aiming to build a more open international cooperation platform, a closer partnership network, and a balanced international governance system. We also encourage future studies to explore the finance implication of this initiative.

Last but not least, as summarised in Table 1, China Securities Regulatory Commission has issued a wide range of regulations. For example, *Securities and Futures Investors' Appropriateness Management Measures* defines experienced investors and inexperienced ones and requests institutional investors provide differentiated service and products. In addition, some policies help to better connect the capital market in China with overseas ones. *The Regulations on the Interconnection Mechanism for Transactions in the Shanghai and Hong Kong Stock Markets* enable mainland investors to trade stocks listed in Hong Kong. *Interim Measures on the Administration of Overseas Trading Participants' and Overseas Brokers' Engagement in the Trading of Domestic Specific Futures Product* permit foreign investors to trade specified future products in China.

Some regulatory changes provide plausible shocks for the identification strategies in empirical corporate finance studies. Atanasov and Black (2016) provide guidelines in improving shock-based causal inference. An ideal shock could be a strong and exogenous reform that separates firms into treated and control samples with reasonably balanced covariates. The evidence of a balanced pre-treatment suggests possible "as-if-random" assignment to treatment. There should be no other confounding shocks that affect the treated and control samples differently. We encourage future shocks-based studies carefully discuss how these conditions are met.

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Table 1. New financial regulations in China since 2015

General	Securities and Futures Investors' Appropriateness Management Measures, 2017-01-10	The Implementation Measures of the Administrative Reconciliation, 2015-07-31	The Regulation the China Securities Regulatory Commission to Entrust Shanghai and Shenzhen Stock Exchange to Implement the Trial operation of Legal Case Inspection, 2015-05-11	Securities and Futures Market Integrity Supervision and Administration Interim Measures, 2015-05-11	
Public Offering	Administrative Measures of Corporate Bond Issuance and Trading, 2015-07-31	Administrative Measures of the Trial Operation of Preferred Stocks, Measures, 2015-05-21			
Listed Firms	Administrative Measures of Material Assets Reorganization of Listed Companies, 2017-01-10	Administrative Measures of Equity Incentive for Listed Companies, 2017-01-10	Administrative Measures of Material Assets Reorganization of Listed Companies, 2015-05-11	Administrative Measures on Acquisition of Listed Companies, 2015-05-11	Some Opinions on Reforming, Improving and Strictly Implementing the Delisting Mechanism of Listed Companies, 2015-05-11
Trading	Regulations on the Interconnection Mechanism for Transactions in the Shanghai and Hong	The Decision to Revise the Provisions on Banning the Entry into the Securities Market, 2015-07-31	Administrative Measures of the Stock Option Trading Trails, 2015-07-31		

	Kong Stock Markets, 2017-01-10				
Securities Firms	Administrative Measures of Securities Company Risk Control Indicators, 2017-01-10				
Funds	Futures Investor Protection Fund Interim Administrative Measures on the Guaranty Funds for Futures Investors 2017-01-10	Administrative Measures of Protection Funds for Securities Investors, 2017-01-10	Interim Administrative Measures of Hong Kong-China Mutual Fund Recognition Scheme, 2015-07-31	Administrative Measures of the Operation of Publicly Offered Securities Investment Funds, 2015-05-11	
Futures	Interim Measures on the Administration of Overseas Trading Participants' and Overseas Brokers' Engagement in the Trading of Domestic Specific Futures Product, 2015-07-31	Administrative Measures for the Supervision of Futures Companies, 2015-05-11			

Note: This table summarizes the new or revised financial regulations promulgated by China Securities Regulatory Commission since 2015.